Divergence: What Comes Next?

Divergence has been a key investment theme over the past couple of years, but this is no time for complacency. Divergence is evolving, transitioning from growth to policy, and can have unpredictable effects. As we head into 2016, the US is nearing its first rate hike in almost a decade as Europe prepares for more aggressive easing. What comes next is unclear, so we recommend focusing on being nimble and employing a more tactical investment approach.

- Our base case is that the Federal Reserve will follow a very shallow trajectory of rate hikes, while central banks in Europe, Japan and China remain committed to stimulus. However, we see risks to this outlook. And in an unchartered and highly experimental policy environment, missteps or surprise developments could have big implications for investors (see Focus, p.3-4).

- In the face of an historic divergence in global central bank policies, we asked Neill Nuttall, Co-CIO of the Global Portfolio Solutions team, to explain the context and implications of these powerful cross currents in today’s markets. Spoiler alert: the prognosis is good for active managers (see Interview, p.5).

- Assuming December’s European Central Bank (ECB) and Fed meetings go as expected, equities remain our preferred asset class and within fixed income we prefer credit to developed market sovereign bonds (see Asset Allocation, p.6).

US and European benchmark short-term yields are further apart than ever...

Source: Bloomberg, as of Nov. 18, 2015.
Macro Trends and Views

**US**
- The October payrolls report was a big positive surprise, with 271K new jobs and a drop in unemployment to 5%.
- The jobs data raised expectations for the Federal Reserve to raise interest rates in December. The odds implied in market pricing rose from roughly 50% to around 70%.
- The Institute for Supply Management (ISM) survey showed a strong rebound in the services sector in October. The non-manufacturing index rose from 56.9 to 59.1, close to the decade-high hit in July.

**Europe**
- The tragic events in Paris on Nov. 13 are likely to have more impact in the political than the economic sphere. We believe some loosening of fiscal targets is possible to allow additional government spending.
- Portugal’s conservative government collapsed on a broad rejection of its legislative agenda. The incoming Socialist administration favors a less-stringent austerity program.
- Recent comments from ECB policymakers suggest a deposit rate cut is likely in December, along with an announcement of expanded quantitative easing (QE).

**Japan**
- Japan’s labor cash earnings edged up 0.6% on the year in September. Base pay was up 0.4%, marking the seventh consecutive month of wage growth.
- The Bank of Japan (BoJ) revised down its economic forecasts, and pushed back its timeline for achieving 2% inflation to the end of 2016. The bank now sees growth of 1.2% this fiscal year and inflation of just 0.1%.
- Japan’s latest inflation data showed the core consumer price index (CPI) down 0.1% on the year to October. However, the “core-core” reading, which excludes energy prices, was up 0.7%.

**Emerging Markets**
- The International Monetary Fund (IMF) announced it will include China’s renminbi in its Special Drawing Rights (SDR) currency basket. The move is an implicit endorsement of the renminbi as a reserve currency.
- China’s manufacturing purchasing manager’s index (PMI) improved slightly, to 48.3 in October, though it remains in contractionary territory. The services PMI came in at 53.1.
- Argentina’s presidential elections handed a surprise victory to center right candidate Mauricio Macri. Macri campaigned on a broad agenda of economic liberalization.
In the post-crisis period of global policy easing, investors made uncomplicated profits on the adage “Don’t fight the central bank.” The question in a divergent environment is, “Which central bank?” Provided that widely held expectations come to pass, the Fed will deliver its long-awaited and heavily telegraphed rate hike in December and the ECB will take a further step down a familiar path of policy easing. But what happens next is unclear, and heading into the new year we are transitioning to an investment environment of greater uncertainty.

Our base case is that the Fed will follow a very shallow trajectory of rate hikes, while the ECB, BoJ and PBoC remain committed to stimulus. The most likely outcome is probably a continuation of the low-growth, low-volatility environment offering positive but modest returns. However, we see risks to this outlook. This policy environment is unchartered and highly experimental territory, and missteps or surprise developments could drive a sharper divergence in policy, with potentially big implications for investors. As a result, we believe this next step toward growth equilibrium requires a nimble and more tactical approach.

Policy uncertainty—the known unknowns
Markets face a range of potentially volatile scenarios in the coming year. The following are questions most relevant to the path of divergence:

- **Is inflation making a comeback?** We see inflation rising gradually toward the 2% target in the US over the next 18 months, but struggling to top 1% in the Eurozone and Japan. However, we see potential upside risks from a range of sources, such as a stronger-than-expected pickup in wage growth and/or inflation expectations, against a backdrop of stabilization or recovery in commodities prices. In the event of an upside inflation surprise, we believe Fed would respond more aggressively than the ECB or BoJ, both of which have more ground to cover to hit their inflation targets. In this scenario policy divergence would be sharper. We think this risk is underpriced by the market, and relatively plausible, since inflationary pressures are more pronounced in the US, where the output gap is narrow and core inflation is already around 1.9%.

- **How will contrasting policies interact?** Central banks tend to be guided primarily by domestic circumstances, but in 2015 many policy statements cited global risks, including China’s slowdown. The Fed invoked “international factors” as a catalyst for dollar strength and tighter financial conditions in the US, which we believe was the key rationale for deferring a rate hike in both June and September. We see a risk that further ECB or BoJ easing could drive another surge of capital flows to higher yielding US assets, causing the Fed to proceed more slowly in its tightening cycle.

On the flipside is the concern that US rate hikes could have ugly spillover effects in regions vulnerable to higher dollar borrowing costs, including parts of EM. A related risk is unintended consequences of policy action. Central banks today are operating in unprecedented conditions, raising the potential for missteps. The reverberations could be significant, since central banks are more implicated in global markets than ever. For instance, QE has expanded some central bank balance sheets to historic proportions, and China’s heavy-handed currency and stock market interventions prompted bouts of volatility over the summer.

- **How high should US rates go?** Fed policymakers have suggested that the longer-term equilibrium policy rate might be lower than in previous cycles, which has contributed to very modest market expectations for the path of hikes. Indeed, the Fed’s latest minutes raised the prospect that the near-term neutral rate was zero, which temporarily drove US bond yields lower despite rising expectations for a December hike. We see potential volatility if the Fed’s models turn out to have underestimated the strength of the US economy and markets have to adjust higher.

![Exhibit 1. US inflation is no longer significantly below target](image-url)
Focus: Questions on Contrasting Policy (cont’d)

Divergence trades played out

Looking ahead, it’s unclear what the net effect of contrasting policy in the world’s largest economies will be. Previous episodes of aggressive easing dampened volatility, weighed heavily on domestic currencies and yields, and contributed to rallies in risk markets, prolonging the expansionary cycles of both credit and equities markets. Monetary policy globally remains historically accommodative, but since the Fed first flagged a withdrawal of accommodation—dating back to the infamous taper tantrum of May 2013—these pre-divergence patterns have begun to break down. We saw this in the sharp backup in German and US rates in May and August 2015. Broadly speaking, we think policy uncertainty, combined with the increased cost of balance sheet for banks, may leave markets somewhat more susceptible to such episodes of flow-driven volatility.

Moreover, we think some popular trades focused on divergence may be close to played out and we are on the lookout for market volatility or corrections heading into the new year. For instance, we believe markets have already largely priced a Fed hike and ECB easing in December’s policy meetings. We are wary of the strong consensus on long dollar/short euro, as we think valuations are getting stretched after this year’s sharp moves. Over the medium term we doubt the euro can drop much below 105 on a sustained basis. We see a similar story in rates markets, as the gap between US and German two-year yields is at historically wide levels. While further widening is possible, we think a peak is probably close, at least under our base case scenario of gradual US hikes.

How are we positioned?

We believe the main risk in the months ahead is complacency, and markets may be over-relying on a benign divergence scenario. In our view, the strategies that worked in a regime of overwhelming policy consensus may not perform well in this post-divergence world of an aging expansion and more disperse returns.

- Currencies: Global policy divergence has arguably had the most direct impact on G3 currencies, driving the dollar sharply higher in 2015 and yen and euro sharply lower. We see potential for these trends to run a little further, but not much given the extent of the moves so far (see currency outlook in Interview, p.5.) Meanwhile, EM currencies have taken the brunt of dollar strength, registering heavy losses over the past 18 months. We are positioning selectively, focusing on markets that we consider oversold and particularly avoiding those most exposed to China’s slowdown.

- Rates: In the short run we are biased to position for a modest increase in US rates, and for declines in Europe. However, over the longer term we expect to take a more tactical approach. In general we see less mileage in trading the direction of individual markets and we tend to prefer trades that profit on the contrasting trends between markets and sectors. For instance, we see opportunities in relative value positions along the US curve, to exploit the differing sensitivities to near-term Fed policy versus inflation pressures and expectations for the longer-term neutral rate. We also favor inflation-linked assets and positioning for long-end rates to rise in markets most exposed to a potential rebound in price pressures.

- Credit: In our fixed income strategies we are modestly overweight corporate credit heading into the new year. Our base case for gradual US hikes and continued policy accommodation in a low but positive growth environment should support further modest gains. However, we are monitoring signs of the market advancing into its late-cycle stage. These include increased leverage and mergers and acquisitions activity.

- Equities: We expect the impact of divergence in monetary policy to be broadly positive for European and Japanese equities, which could lead them to further outperform US equities in local currency in 2016. Any increase in economic growth and inflation in both regions would be a positive environment for equities, while continued weakness in the euro and yen could further boost revenues for the many export-oriented European and Japanese companies. In the US, we expect some rotation away from higher-yielding sectors such as real estate investment trusts (REITs), utilities and consumer staples, all of which are relatively expensive, toward areas like banks, which can benefit from higher rates.

- EM: Broadly speaking we think EM debt and equities are less vulnerable to higher US rates today, since many countries have shifted substantial proportions of their debt into local currencies. Moreover, this tightening cycle has been well telegraphed, and EM has already experienced significant outflows in preparation. We see potential for some economies in emerging Europe to benefit from a renewed grasp for yield as ECB policy drives domestic yields lower still.

Exhibit 2. G3 currencies have moved a long way

Source: Bloomberg, as of Nov. 24, 2015.
Interview: Looking beyond Divergence

Divergence is one of our longer-standing investment themes at GSAM, but it’s proven a durable and at times unpredictable driver of global markets. In the face of a historic divergence in central bank policy, we asked Neill Nuttall, Co-CIO of the Global Portfolio Solutions team, to explain the context and implications of these powerful cross currents in today’s markets. Spoiler alert: the prognosis is good for active managers.

How has the divergence theme evolved?

Divergence until around mid-2014 was about economic divergence, with the US leading in terms of the post-2008 recovery. Since then we have focused more on policy divergence. The Fed and Bank of England (BoE) were the first to stop expanding their balance sheets, while the BoJ has continued to do so, and the ECB embarked on QE at the start of 2015. Elsewhere, though not following full-blown QE, we’ve seen policy easing in China, with a broad range of monetary and fiscal stimulus over time.

What’s happening now?

In December we expect policy divergence to intensify, with the Fed likely raising interest rates and the ECB announcing further easing. So far ECB President Mario Draghi’s never failed to deliver on a promise, and he has delivered to the upside. We don’t expect much more easing from Japan in the near term—new policy is more likely to be on the structural and fiscal side, though the BoJ’s balance sheet will continue to expand.

What are the economic implications of these monetary policy developments?

While economic growth has been converging for a while, we still see divergent inflation trends and we think policy is contributing. Monetary easing in the Eurozone and Japan has the explicit objective of currency depreciation—to import inflation, that is, by exporting deflation. This led us to consider where deflation is going and which countries are impacted.

We think open economies that derive the bulk of their growth from exports, such as South Korea, may be most exposed to deflationary pressure. We believe the US is fairly well insulated, as a relatively closed economy deriving 70% of its GDP from consumer demand. That said, it’s worth noting that the US corporate sector is more exposed than the broader US economy to global forces, with around 50% of US companies deriving earnings primarily from external demand.

Where do you see the most direct market impact of divergence?

Currencies have moved a long way in this divergent environment. The euro and yen have depreciated sharply and the US dollar, which has been on a secular strengthening trend since 2011, has surged 20% since mid-2014. But we think further big moves are unlikely beyond the near-term trend since 2011, has surged 20% since mid-2014. But we think further big moves are unlikely beyond the near-term volatility of December’s potential policy action.

We think the dollar is now slightly overvalued. We are also conscious that historically it’s not a given that the dollar appreciates in the first year of a rate hike cycle. In this case the prospects are further discounted by the recent big rally.

The euro is the mirror image to the dollar in that it’s undervalued, but not significantly so. The euro could weaken further, but we don’t see a lot of downside and certainly we think ECB policy would be aimed at preventing strength on a relative basis rather than driving a much sharper depreciation. We think the Japanese yen is the most undervalued of the major currencies and we would be surprised to see yen/dollar above 130. The current level of yen weakness is providing accommodation for Japan’s economy, in our view, and we don’t see a strong near-term case to ease further.

How does divergence inform your investment strategy?

This is a great time for active management, a great time for bottom-up stock pickers. Divergence doesn’t affect all markets in the same way—there are winners and losers. As asset allocators we see opportunities in playing this dispersion. We see alpha opportunities in distinguishing between economies based on factors such as the strength of their current account, their ability to generate domestic demand and their exposure to global weaknesses, such as China’s slowdown and declining demand for commodities.

That said, our global outlook is still broadly positive as we feel global growth will improve. We are positive on equities and on the outlook for Europe in particular. We have scaled back our US overweight in the last year, and are likely to proceed gradually toward neutral. Broadly speaking we are now more likely to have relative value and sectoral positions. We like Japan despite its relapse into recession, as underlying domestic demand has improved. In EM we are introducing exposure selectively, and India is among our favored markets. We believe the economies with the best prospects in the coming year are commodity importers, and those with strong domestic demand and current account surpluses. For instance, despite flattening exports, growth has held up reasonably well in parts of South East Asia, such as Indonesia and the Philippines, where consumption is a significant economic driver.

Goldman Sachs Asset Management 5 November 2015
It is now more than eight years since the equity market peak in 2007. Some commentators are looking at that figure relative to a post-war average of less than seven years, coupled with high valuations, and arguing that an end to the cycle is drawing close. We disagree, and we see three big macro drivers of asset prices next year. We expect the expansionary growth phase to continue through 2016. We believe inflation will rise, but not to troublesome levels. We expect to encounter renewed policy divergence after a mid-year pause, with the US tightening as others ease. On this thesis, equities remain our preferred asset class. Within fixed income we prefer credit to Treasuries, but we expect returns in both to be muted.

Economic expansion to continue
We believe US growth can keep up the pace seen this year, with strong domestic demand helped by job creation and wage increases. Moreover, stabilizing global growth should support US output by easing the headwinds of a stronger dollar. In Europe the recovery is broadening. Easy policy, currency weakness, less fiscal drag and more available credit gives us confidence growth momentum can be sustained. Chinese policy should continue to provide a backstop for the domestic economy—though growth is slowing and transitioning somewhat awkwardly—and for broader EM too. Globally we expect growth to be strong enough to chip away at unemployment rates and support asset prices.

Inflation risks skewed to the upside
We highlighted last month how underlying price trends were less deflationary than some commentators suggest. Base effects are actually strongly inflationary as energy price declines fall out of year-on-year data. Furthermore, signs of capacity tightening in the US and UK are likely to manifest in domestically-generated inflationary pressures, tempered by the deflationary weight of currency strength. Overall we expect prices to rise, quicker than many think, but without significantly overshooting central bank targets.

Policy divergence back in the headlights
As we write in our Focus (see p.3-4) we expect renewed vigor in policy divergence, in particular between the US and Europe. We expect the ECB to ease further in an attempt to drive inflation up again. The outlook for the BoJ is more uncertain, with asset holdings already at 70% of GDP, a weak currency and the lowest unemployment rate since 1997 undermining the case for further easing.

Risks: economic, market and political
We see three key risks to our benign outlook. First, we are concerned an inflation scare could emerge in the US as disappearing base effects lead to higher inflation in an environment of low unemployment. This could cause volatility and drawdowns, even if inflation is contained as we expect. Second, EM in general remains the weakest point for global growth, and China in particular. Adjustment pressures are large given the decline in oil prices, US policy tightening and the ongoing shift in Chinese demand patterns, and some countries are ill-prepared in terms of existing imbalances. We continue to favor Indian equities. As the year unfolds we expect the adjustment process to create selective opportunities, as much weakness has been priced already. Finally, in Europe, still-high debt levels and social strains from austerity and geopolitical pressures are latent risks that could flare again.

Equities over credit over bonds
In terms of asset allocation, we believe equity valuations are fair given the macro environment and we lean towards markets outside the US, especially Europe. We think we are in the later stages of the credit cycle, and we are selective across the fixed income spectrum. We expect higher yields in the US and more dollar strength as policy tightens. We look forward to 2016 with less trepidation than many.

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**Asset Allocation Views: Key Market Drivers in 2016**

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Appendix: GSAM Growth Forecasts and Asset Valuation

### GDP Growth Forecasts: GSAM vs Consensus

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*As of September 2015. Source: GSAM and Bloomberg

### Equity Valuation Across Advanced and Growth Markets

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<th>Country</th>
<th>CAPE*</th>
<th>FY1 PE</th>
<th>Price/Book</th>
<th>Dividend Yield</th>
<th>Earnings Momentum**</th>
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<td>Level</td>
<td>% time cheaper***</td>
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* Cyclically-adjusted PE ratio (5-yr rolling window). ** % change in 1-yr fwd EPS over last 3 months. *** Current percentile relative to full history

As of November 2015. All data based on MSCI country indices. Source: Datastream, GSAM calculations

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### US Equity Risk Premium

**US Equity Risk Premium**

Source: GSAM calculations

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### Equity Risk Premium for the BRICs

**Equity Risk Premium for the BRICs**

Source: GSAM calculations
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